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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET In the last Letter I ventured the guess that "... the near-term picture is all right, but the long-term is not." The action of last week would certainly seem to confirm the first half of that statement.

As has happened over and over again during the past seven months, each time the Averages work into position to display potential weakness, the situation is resolved to the upside. On May 17, Industrials recorded a 1962-63 recovery high of 724.81. Over the next few days (see chart No. 1) the senior Average lost approximately seven points, thereby forming a little downward zig-zag. Despite the Industrial decline, Rails continued to establish new recovery highs. On May 29 both Averages again rallied "in gear", and that day saw Rails close within a fraction of their 1959 (173.56) peak while Industrials ended the session within a few points of their preceding (724.81) 1963 recovery high. On May 31 (Friday) both Averages rose to new 1963 recovery highs, and this move was confirmed by a fresh recovery high in the advance-decline ratio. Thus a situation which contained the seeds of trouble turned out to be merely a "step back" in preparation for another upward surge.

It should be remembered, however, that this is the fourth time within two years that the Industrial Average has moved into the 720-734 area. The first instance was during August-September, 1961. The subsequent October decline was forecast at that time by a refusal of Rails and the A-D ratio to confirm the rising Industrial Average. The second assault on the 720-734 area came in November-December, 1961, and again Rails and the A-D ratio diverged in the face of an historic Industrial high. Finally, during March, 1962, Industrials advanced to 723.54, but Rails were already engaged in a persistent decline (a decline that began in January, 1962) and the Rail divergence was abetted by a stubborn series of non-confirmations on the part of the A-D ratio. This series of divergences lead to the worst market collapse since 1937.

The current advance (so far) contains none of the ominous technical overtones of 1961 or 1962. If there is anything dangerous in the big picture at this writing, it is the fact that a new Industrial high in the near future would present a series of three successive highs (i.e., 1959, 1961 and now) against a corresponding series of three successively lower peaks

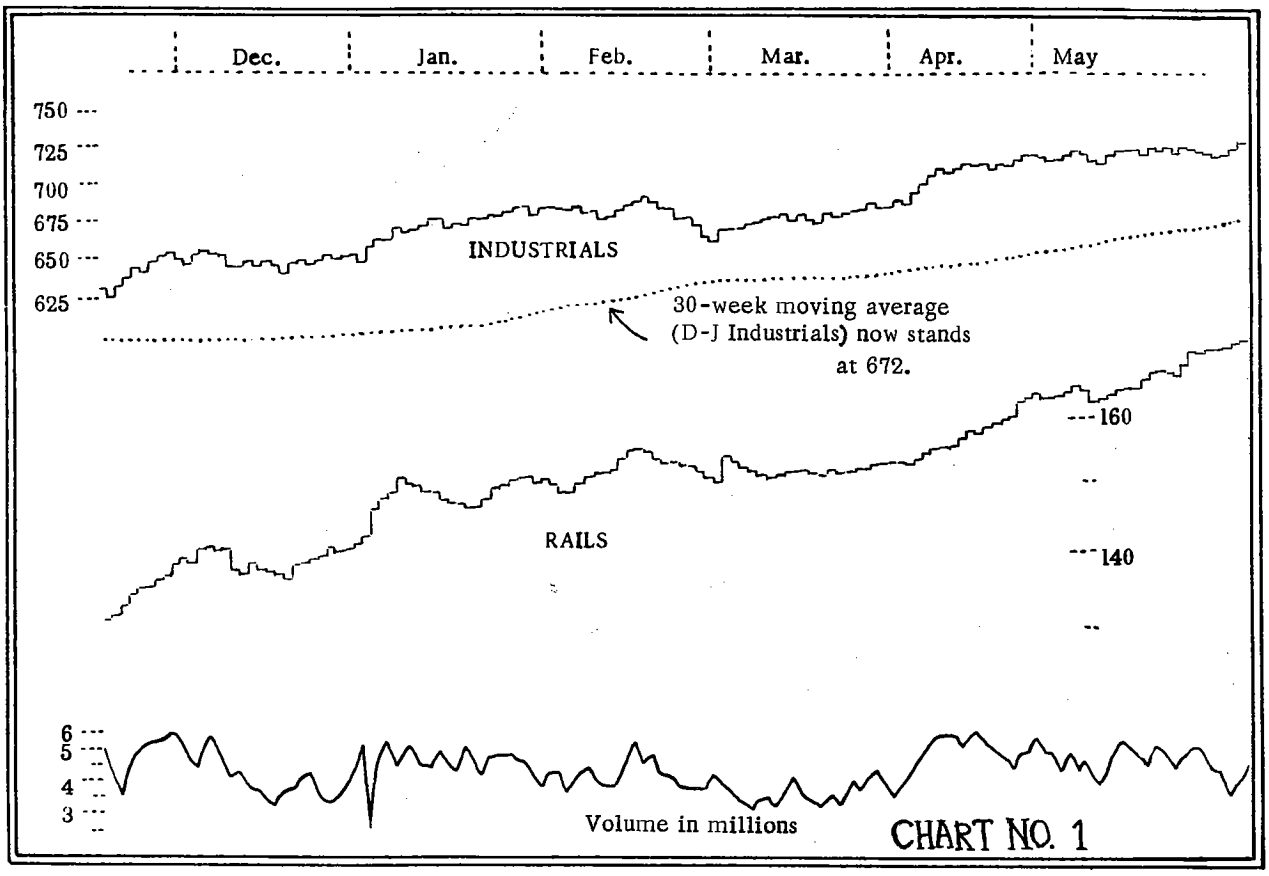
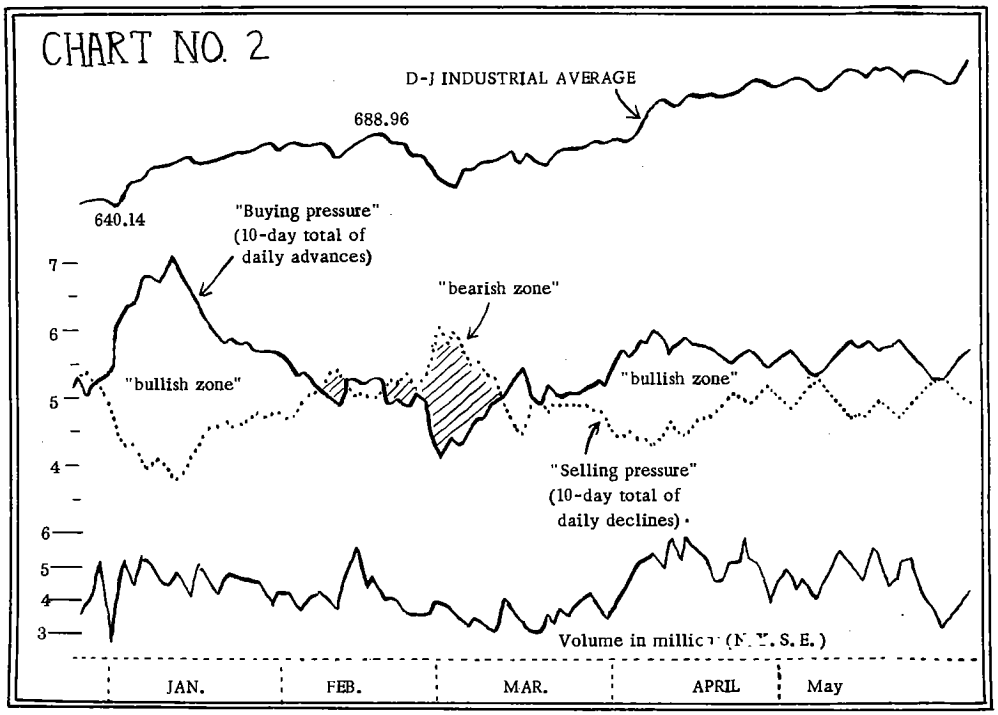


CHART NO. 1

on the A-D ratio (see Letter 215). To my mind, such a situation would contain bearish implications for the big picture, but would not prevent a final run-up or "blow-off" in the market on an intermediate term basis).



BUYING AND SELLING PRESSURE

On May 28, following 48 consecutive days in which the buying line held in a bullish position above the selling line, the two indicators crossed by the barest fraction (see chart No. 2). As had been the case at the last bearish crossing in February and March, daily volume immediately shrank to below 4 million shares. Thus, the implications (so far) are that whenever the market enters a corrective period (i.e., when the selling line becomes dominant) the volume of transactions recedes, and this means that selling pressure is held to minimal proportions.

Important selling pressure is indicated when downside action brings forth increasingly heavy offerings (volume). At such times it can be said that more people are willing to sell as prices decline. Unimportant selling is indicated when volume contracts as prices decline. The obvious implication here is that lower prices have dried up the potential supply. Based on the graph, the latter situation continues in effect at this time. Volume still contracts as the market declines, and it dries up drastically when the selling pressure line on the graph rises even slightly above the buying line. Sooner or later we will have a situation in which volume increases noticeably as the selling pressure line rises above the buying line. When that time comes, the "danger flags" will be flying . But for now, the market continues to act well.

On May 29 a sharp rally occurred, followed by a further dynamic rally on May 31. The action during these two days succeeded in raising the buying line above the selling line again, and this means that buying has held above selling for 50 out of the last 51 days. Since the buying and selling lines normally cross and recross every 15 to 30 days, the picture these two indicators are now presenting is one of outstanding strength.

THE BIG PICTURE Wall Street has shown an increasing willingness to accept the idea that the Rail Average always points the true direction of the market. This is rather ironical, and I well remember that when I wrote my first article for Barron's in 1958, the suggestion that the movements of the Rail Averages meant anything at all was greeted as a complete absurdity. In fact, leading analysts in 1958 expended much time and effort in explaining why "the rail industry was finished" and why the movements of "a handful of corporate relics" could have no bearing on the future action of the stock market.

Actually, both extremes are incorrect. The movements of the carriers, as far as Dow's Theory is concerned, are every bit as important as the movements of the Industrials. The principle which states that valid inferences may be drawn only from the actions of both Averages remains a cornerstone of Dow's Theory, and time has proved the wisdom of this approach. But the idea that the Rails invariably lead the way cannot be justified. As recently as 1962, in fact, Rails attempted to "lead the way" but Industrials would not follow. In October, 1962, Rails penetrated their June low. That penetration was not confirmed by Industrials, and the market turned around in one of the most extraordinary reversals and recoveries in history.

There is no doubt that the Rail shares tend to be ignored by the public. They are creatures without glamour or true growth characteristics -- moreover, they are associated in most people's minds with the dusty glories of the past, not the electronic magic of the future. For these reasons, the carriers are usually moved by "professional money". Professionals also remain interested in the rails because these stocks are, in many cases, highly leveraged (with debt). Rails are more likely to outperform the general market during a period of rising carloadings and economic expansion. Conversely, during a recession rails are adversely affected as carloadings shrink, and this coupled with the high debt structure may cause a virtual collapse in rail earnings. Thus, in the third quarter of the recession year 1960 many observers were shocked to learn that the D-J Rail Average produced an actual deficit of 44¢.

Nevertheless, proof of the wisdom of the continuing professional interest in rails is provided by the accompanying chart (chart No. 3 -- page 3). Note that on the rise since 1962, the Rail Average easily outperformed the Industrial Average on

a percentage basis(the chart is drawn to logarithmic proportions and thus shows percentage of increase or decrease).

The 1962 "crash" took the Rail Average to 114.86, nine points under its 1960 low. Subsequently, the 1962-63 recovery movement took Rails above their 1961 peak of 152.92. During the past few weeks the carrier Average has penetrated the long descending trendling formed by the 1956 (181.23) and 1959 (173.56) peaks. Although "formations" play no part in Dow's classic Theory, the pattern formed in the Rail Average is that of a huge triangle which is currently "breaking out" on the upside. The structure would seem to imply considerable force, and it will be interesting to see whether the present Rail thrust will carry above the 1959 and 1956 highs.

As seen on the same chart, the Industrial Average continues to push towards the underside of the long 1949-61 trendline, a trendline which was shattered during the 1962 decline. In previous Letters I have stated that it is most unusual in such circumstances for the price movement to rise above a broken trendline. The nearness of Industrials to the trendline suggests that they are in position to encounter important resistance.

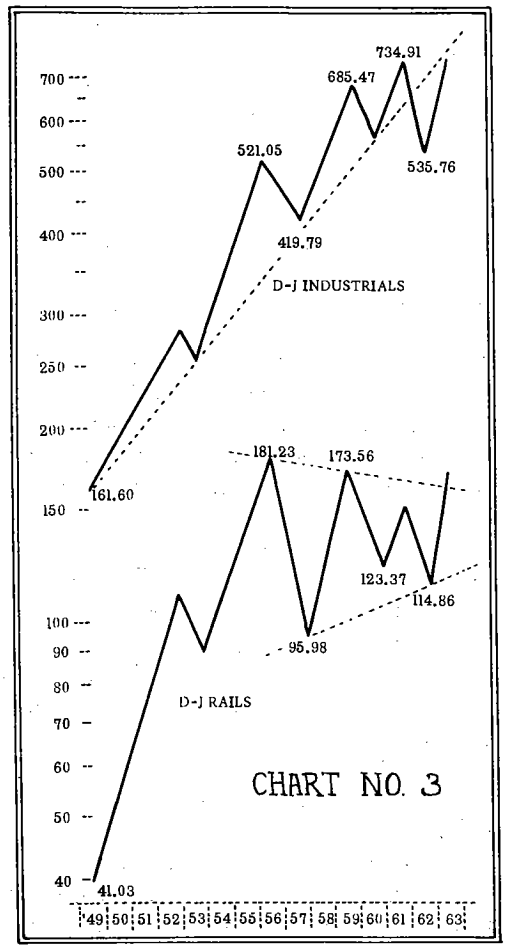


CHART NO. 3

SPECULATION Letter 214 included a study of four important measurements of speculative sentiment. That study is brought up to date with this Letter (see Chart No. 4). It is worth noting that over the past six weeks there has been a slight but noticeable increase in speculative sentiment in three of the four components of the chart. The only component which has not shown any increase in speculative sentiment is the odd-lot trading ratio (i.e., the comparison of odd-lot volume with total round-lot volume). Do these minor increases in the speculative indicators suggest that something bigger is "in the wind"? They could, and if Industrials better their all-time high of 734.91, it will be these speculative indexes which will point the difference between a difficult and a highly profitable market. Obviously, if this market does become really speculative, it will be reflected in impressive percentage swings in low-priced stocks. For this reason, I will be paying particularly close attention to chart No. 4 in coming Letters.

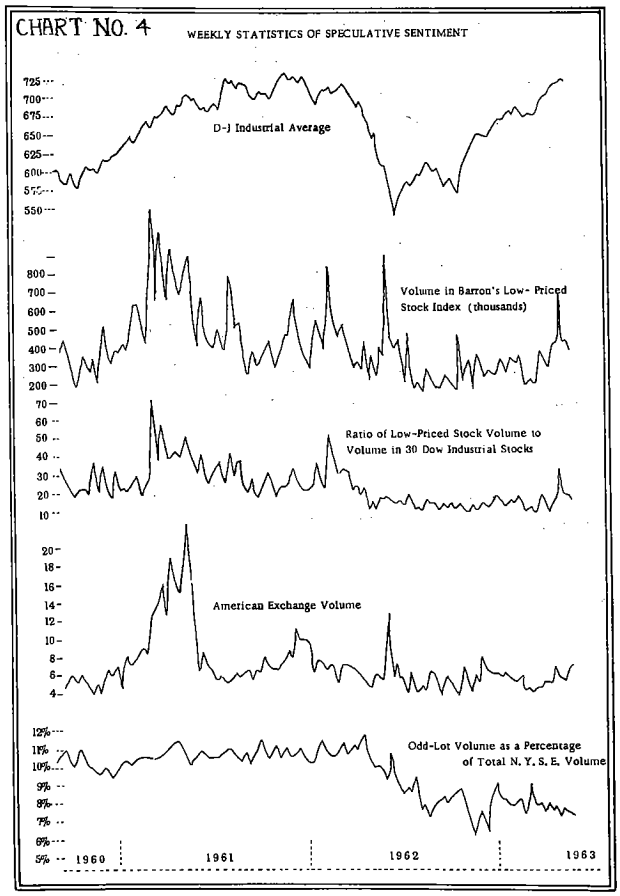


CHART NO. 4
WEEKLY STATISTICS OF SPECULATIVE SENTIMENT
D-J Industrial Average
Volume in Barron's Low-Priced Stock Index (thousands)
Ratio of Low-Priced Stock Volume to Volume in 30 Dow Industrial Stocks
American Exchange Volume
Odd-Lot Volume as a Percentage of Total N.Y.S.E. Volume
1960
1961
1962
1963

Can a market "top out" without showing any further indications of speculative excesses than those which have so far appeared? It has occurred in the past, but the resultant declines could not be described as true bear markets. In mid-1947 (following the 1946 crash) the market approached the old 1946 high, and amid an atmosphere which can only be described as "tedious" the market turned down -- finally to halt within a few points of the 1946 low. In mid-1948 (amid heavy odd-lot selling) the market again approached the 1946 high of 212.50, then turned down a second time. By June, 1949, the Industrial Average reached the 1946 low for the third time in three years.

Could history repeat? Could the current price structure buckle in the face of public apathy and speculative listlessness? It could happen, but one wonders if a true bear market would develop from such an atmosphere. If important weakness does develop, we will simply have to depend on the probability that it will show itself quickly in one of our indices of market action. Major collapses stem from secondary weakness, and secondary weakness grows out of minor weakness. This is the reason why minor indications can never be ignored, particularly following a price rise of the proportions of the 1962-63 advance.

STOCKS Of 420 stocks which are tabulated at this office each week, 318 or 76% are now holding above their 30-week moving average (no change from last week).

Outstanding group relative strength continues to be shown by stocks which deal in "wheels and wings" -- rails, airlines and auto manufactures. Poor relative strength continues in paper and aircraft (friends in San Diego tell me that as far as the bad showing in aircrafts is concerned: "All the big contracts are out; all the good news is out"). Groups now weakening include oils, utilities and finance (i.e., saving and loan and small loan companies). Gathering relative strength is now being evidenced in the electronics groups (Admiral, Litton, Magnavox, RCA).

Many subscribers have asked: "Whatever happened to the gold stocks?" The answer is "nothing yet." However, as seen on the weekly chart of Campbell Red Lake (representative of the group), the golds are currently in one of the longest, strangest sideways movements on the Board. Since 1960 Campbell has been fluctuating within a huge symmetrical triangle. One fine day it is going to break out, and when it does it should be something to see. Until then, I think it is worth owning at its current price (along with Dome Mines). The long, gradually rising relative strength line on Campbell suggests that the eventual breakout will be up.

The motion picture group has been staging a fairly good recovery, and Twentieth Century has already recovered the major part of its 1962 losses. Paramount pushed out of a long base just two weeks ago and should be ready for its upward move. A laggard in the group is MGM, but the weekly chart (below) shows a very large triangle formed since 1962. Last week this triangle broke out on the upside, and this could be the beginning of an important move for MGM. Giant consolidation patterns such as the one seen in MGM are rare in this market. Normally, the larger the pattern, the greater the ensuing movement.

Dresser Industries shows a breakout from a large "head-and-shoulders" reversal pattern. The stock pulled back to the resistance area (dotted line) around 25 where it seems to be consolidating. The stock should be a good secondary issue for those who are willing to bet that this market is going to turn speculative.

Charts on this page courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.